Free trade on trial

MEXICO CITY AND WASHINGTON, DC

The North American Free-Trade Agreement is ten years old this week. It has proved a success, though not in the way its advocates promised

FROM the start, the North American Free-Trade Agreement was bitterly controversial in all three of the countries taking part—the United States, Canada and Mexico. Its terms, which went into effect on January 1st 1994, were argued over line by line: despite its name, the agreement fell far short of scrapping all trade restrictions, and the fine print of the various exemptions and exclusions gave rise to heated argument. More than this, the agreement was attacked as bad in principle. Everybody recognised that NAFTA was an extraordinarily bold attempt to accelerate economic integration—or, as critics put it, an experiment in reckless globalisation. As such, they said, it would destroy jobs, make the poor worse off and start an environmental race to the bottom.

Equally, advocates of the agreement made some bold claims about the good it would bring. Far from destroying jobs, it would create lots of new and better ones; incomes would rise and the poor would benefit proportionately; growth would accelerate and, to the extent that this posed environmental challenges, extra resources would be available to meet them.

Unsurprisingly, a mere ten years' experience has settled few of these quarrels. Today, most trade economists read the evidence as saying that NAFTA has worked: intra-area trade and foreign investment have expanded greatly. Trade sceptics and anti-globalists look at the same history and feel no less vindicated. Look at Mexico's growth since 1994, they say—dismal for much of the period. Look at the contraction of manufacturing employment in the United States. As for the environment, go to the places south of the border where the *maquiladoras* cluster, and take a deep breath.

Politically, the sceptics, ten years on, can fairly claim victory. NAFTA is unpopular in all three countries. In Mexico, which stood to gain most from freer trade (since its barriers were so much higher at the outset) and which has benefited greatly according to most economic appraisals, the agreement is widely regarded as having been useless or worse. In a poll conducted at the end of 2002 by Ipsos-Reid for the Woodrow Wilson Centre in Washington, only 29% of Mexicans interviewed said that NAFTA has benefited Mexico; 33% thought that it had hurt the country and 33% said that it had made no difference. In all three countries, the perceived results of NAFTA seem to have eroded support for further trade liberalisation.

NAFTA's champions are partly to blame for this: they oversold their case. It was never plausible, for instance, to expect that NAFTA would be a net creator of jobs. Trade policy is not a driver of overall employment; it affects the pattern of jobs, rather than the total number. To the extent that NAFTA succeeds in stimulating trade and cross-border flows of investment, jobs in each member country are created in some industries and destroyed in others. This was bound to be a painful process for some, even if it succeeded in making the member countries' economies more efficient overall, and hence in raising average incomes. Here was another instance of false advertising: NAFTA was never going to be, as some enthusiasts claimed, a win-win proposition for all of North America's citizens, even if all three countries could hope to gain in the aggregate.

Yes, it worked

So far as its economic effects are concerned, the right question to ask of NAFTA is simply whether it indeed succeeded in stimulating trade and investment. The answer is clear: it did (see charts on next page). In 1990 the United States' exports to, and imports from, Canada and Mexico accounted for about a quarter of its trade; now they account for about a third. That is a dramatic switch, especially when one ▸▸

notes that the United States' non-NAFTA trade has itself grown strongly over the period. There is plenty of economic evidence to suggest that expanded trade, as a rule, raises incomes and future rates of growth. So it is pretty clear that NAFTA achieved as much as one could sensibly have expected it to achieve.

Why then is the agreement so widely regarded by non-economists as a failure? The answer lies partly in the interplay of politics and economics, and accordingly is different in each of the member countries. But one theme is common to all three: a tendency to blame NAFTA in particular, and international integration in general, for every economic disappointment of the past ten years, however tenuous the connection may be.

Debate in the United States has been preoccupied by fears over loss of jobs—by the "giant sucking sound" of work moving south, in Ross Perot's phrase from the early 1990s. A variety of estimates of NAFTA's direct effect on American labour have been made—with job losses running as high, according to one disputed study, as 110,000 a year between 1994 and 2000.

But, as already noted, direct losses do not tell the whole story: changing the pattern of employment is after all one of the reasons for promoting trade. So long as lost jobs are balanced by new ones, the overall effect on employment will be small. As Gary Hufbauer and Jeffrey Schott of the Institute for International Economics point out, between 1994 and 2000 the United States economy created more than 2m new jobs a year. Manufacturing employment has dwindled (with NAFTA as one relatively minor cause among many); jobs in other industries have more than made up the losses. And since the mid-1990s, at any rate, the great majority of new jobs created have paid above-median wages.

Against this background, even NAFTA's highest estimated direct losses can hardly be regarded as crippling. America's evident disenchantment with liberal trade has less to do with the economic depredations of the 1990s—when the economy boomed, in fact—than with a political failure to make the case for free trade against its increasingly vocal and well-organised opponents.

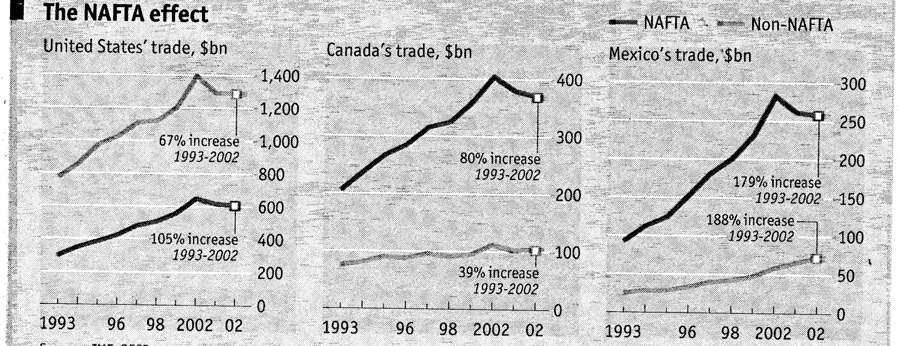
In Canada, initial concerns were less to do with the flight of low-skilled manufacturing jobs, because trade with Mexico seemed a less pressing issue than it was for the United States, and more to do with other sorts of international competition. As it turned out, Canadian unemployment fell markedly during the 1990s (from 11% of the labour force in 1993 to 7% in 2000). The main fear, instead, was that closer integration with the American economy would threaten Canada's European-style social-welfare model, either by leading certain practices and policies (such as the generous minimum wage) to be regarded as directly uncompetitive, or else by pressing down on the country's base of corporate and personal taxes, thereby starving public-spending programmes of resources.

Canadian public spending was indeed squeezed somewhat during the 1990s—not because NAFTA eroded the tax base, but because public borrowing had reached an unsustainable level of 8% of GDP in the early 1990s. The problem was successfully addressed: Canada has lately run a budget surplus. Despite the fiscal retrenchment, and despite NAFTA, its social-welfare model stands intact, and in sharp contrast with that of the United States. The fact is, most Canadians are willing to pay the higher taxes that are required to finance generous public services (including universal health care). As long as this remains true, NAFTA poses no threat to the Canadian way of life.

Down south

What about Mexico? The very point of NAFTA, to listen to some of its advocates, was to destroy the Mexican way of life—and replace it with something better. The overall verdict on NAFTA rests heavily on whether the pact proved a success for the country it was bound to affect most. NAFTA was never going to have much impact on the huge economy of the United States. But as recently as the mid-1980s Mexico was still an almost completely closed economy. For Mexico, NAFTA promised to be revolutionary.

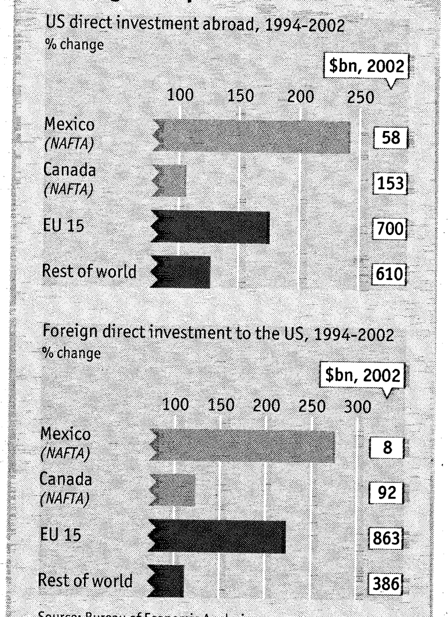
The NAFTA effect



Sources: IMF; OECD

Non-comparable scales

Pooling the capital



Source: Bureau of Economic Analysis

Unfortunately, soon after NAFTA came into effect, the country was overwhelmed by a largely unrelated economic shock, the Tequila crisis of 1994-95. Huge capital inflows into the country in the early 1990s were followed by rapid outflows towards the end of 1994, causing the peso to plunge. The authorities were forced to float the currency on December 20th of that year, and before long it had lost nearly half of its value against the dollar.

The financial system collapsed, with many banks going under as years of bad loans were exposed. In the end, at huge cost, the government had to bail out the banks. The repercussions of the Tequila crisis for Mexico were immense. The banks, for instance, have still not fully recovered, and the subsequent lack of credit and financial services does much to explain the anaemic performance of Mexico's domestic economy over the past decade. All this makes judging the effects of NAFTA very difficult.

Take real wages. Although Mexican workers have managed impressive gains in productivity over the past ten years to compete with America and Canada, real wages have not kept pace. This allows NAFTA's critics to argue that the typical Mexican has not benefited from the treaty as he should have done, and that big business has creamed off most of the profits.

The truth is different. The Tequila crisis led to an immediate fall of about 20% in Mexican wages (more in dollar terms), while productivity kept going up. So although real wages have been rising ever since the country began to recover in 1996, they are only just reaching their levels of before the crisis. The lasting influence of ▸▸

higher productivity on wages may not be clear for another decade, when the effects of the Tequila crisis have fully faded away. That said, the country recovered much more quickly from the Tequila crisis than from its previous financial crises in 1982 and 1986—and this was indeed mainly due to NAFTA. Speedily arranged help from Bill Clinton's administration spurred the strong recovery. That aid sprang from America's desire not to let its new partner go under.

The closeness of the link to America, the destination of almost 90% of Mexican exports, is of course a disadvantage when America goes into recession, as it did in 2001. Mexico lost thousands of export jobs in that downswing. On the other hand, NAFTA has insulated Mexico against the financial instability that swept through Argentina, Brazil and other parts of South America in the first years of the new century. It has given Mexico an investment-grade credit rating, and allowed it to issue—almost uniquely in Latin America—very long-term local-currency bonds and mortgage-backed securities. Investors now think of Mexico more as a North American than a Latin American country.

Former President Carlos Salinas de Gortari embraced NAFTA mostly to attract more foreign investment and to boost the *maquiladora* manufacturers (set up in 1965 to allow tariff-free import of materials for assembly and re-export to the United States). Mexico's trade has surged, especially with the United States. In 2002 it totalled $250 billion, and the country's traditional deficit with its northern neighbour has been converted into a surplus in every year of NAFTA membership.

After 1994 foreign direct investment also shot up. NAFTA was designed to make investors feel more legally secure, and foreign companies duly poured in to take advantage of Mexico's closeness to the world's wealthiest market. The rise in export manufacturing also greatly reduced the country's dependence on the volatile price of oil. Moreover, NAFTA jobs in export businesses have usually been good ones, paying on average substantially more than jobs in the rest of the economy.

It hardly needs saying, however, that Mexico has no shortage of problems that NAFTA has so far failed to solve. One is the challenge of providing decently paid work for all those who need it. The chief symptom of the failure to do that, of course, is the continuing outflow of migrants.

The biggest pressure on emigration, in turn, is the crisis in the countryside. The traditional Mexican farmer had about eight hectares of his own land and some communal land for livestock. This made his family self-sufficient in everything from maize and beans to meat and milk. Even before NAFTA this traditional rural economy was disappearing, as demographic pressure caused the land to be subdivided, and many *campesinos* now eke out a living year by year, ever on the edge of disaster. "If the weather does not help us, we are completely lost," says Dionisio Garcia, who farms a smallholding in the southern state of Tlaxcala.

Most of Mr Garcia's colleagues have simply given up. He estimates that up to 90% of the heads of families in his area now spend at least six months of the year working in Canada or the United States. "What they earn there in four months, we don't earn here in a year," he says. They are part of an estimated 1.3m people who have left the land since 1994. The young, besides, are no longer much interested in making a living from the land; they are going off to drive taxis in the city, or to sell air-conditioners.

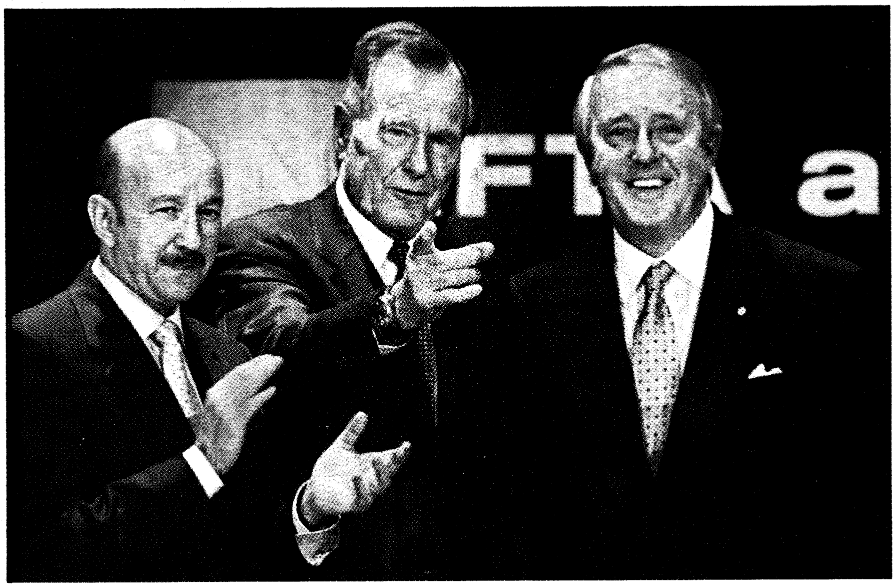
Mr Garcia says that he can no longer sell his surplus maize to Mexican wholesalers because he has been undercut by cheaper and better American imports. For him, NAFTA and free trade have been "totally bad". And yet trade in Mexico's two staples, maize and beans, is still not free; the last tariffs will remain until 2008.

The flood of corn from America's midwest is the most hated aspect of NAFTA for Mexicans. The government argues that it has to import so much because Mexico's small farmers cannot feed all Mexicans, let alone turn a profit. But critics allege that Americans are selling so cheap that they are, in effect, dumping the stuff. Besides, they receive vast subsidies from their government. NAFTA explicitly pledges to eliminate these, but it has not done so yet.

Some Mexican farmers have shown that they can make a good living under NAFTA. Export earnings from horticulture have tripled since 1994, to over $3.5 billion; exports of fresh vegetables have risen by 80% and fresh fruit by 90%. If farmers can exploit local conditions and invest in a crop that can be exported during American or European winters, they can make money. The star performer is the Hass avocado from the state of Michoacán, in the west of Mexico, where the climate is mild and the soil fertile. Before NAFTA, the United States banned it because of infestation by insects. After a clean-up and monitoring operation, supervised under NAFTA rules, avocados from Michoacán were accepted into most states of America in 1997. Exports have increased from 6,000 tonnes to 30,000 tonnes a year.

Overall, though, Mexico continues to rely on low-cost assembly, and the advantage of preferential entry into the American market. Increasingly, other countries offer cheaper labour. With China's accession to the World Trade Organisation, Mexico has already lost much of the advantage that NAFTA gave it. Many Mexicans still think that a reviving American economy, by itself, can buoy their own. But in the next upswing, as America deepens its trade links with other states, this may prove untrue.

NAFTA alone has not been enough to modernise the country or guarantee prosperity. It was never reasonable to suppose that it would be—though that did not stop many of its advocates saying so. NAFTA has spurred trade for all its members. That is a good thing. But trade can do only so much. Sadly, successive Mexican governments have failed to deal with the problems—corruption, poor education, red tape, crumbling infrastructure, lack of credit and a puny tax base—that have prevented Mexicans and foreign investors alike from exploiting the openings which freer trade afforded. Don't blame NAFTA for that. ■



Salinas, Bush and Mulroney: the architects